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FOMC Briefing
Donald L. Kohn

The staff forecast suggests that the Committee will need to tighten at some point to contain inflation--a characteristic underscored by the results of the longer-run simulations in the bluebook. At the same time, uncertainties about important relationships in forecasts of inflation have reduced confidence in some of the key leading indicators of inflation pressures, raising questions about how the Committee can best judge that the time has come to act pre-emptively to head off an intensification of price pressures if the staff has correctly identified the underlying situation. I will be addressing each of these issues.

The basic message of the forecast and its extension in the bluebook is that the economy is operating a little beyond its sustainable level so that inflationary pressures are mounting, and because policy is not now positioned to correct this situation, the imbalance will tend to worsen over time. Real short- and long-term rates are not now low by historical standards, but, as Mike noted, the rise in equity prices and the lack of caution by credit suppliers are seen as contributing to _overall_ financial conditions that are too easy to contain inflation. The effects of the high stock market are illustrated in the stock-market shock simulations in the bluebook. While those simulations dealt with a stock market drop, they are symmetrical. They suggest that a 25 percent overvaluation of the market--the ballpark prediction from a number of models--would, other things equal, raise the equilibrium funds rate by 50 basis points.

In the context of the staff forecast, the degree of stimulus in current policy is probably not large. Indeed, simply fixing the real funds rate, rather than fixing the nominal rate and allowing the real rate to fall with higher inflation over the next few years, likely would flatten to a considerable extent the upward trajectory in inflation. But it would not be enough under the forecast. Without some near-term rise in the real funds rate to bring demand back in line with the economy's productive capacity, inflation would tend to worsen over coming years.

For a variety of reasons use of the core PCE chain weight index in the bluebook charts probably presents an exaggerated picture of the degree of underlying deterioration in inflation. Moreover, a core index certainly is suspect as a proxy for inflation expectations, which are likely built on observations of all prices, and so the real rate would not drop as rapidly as depicted were the nominal funds rate maintained. Nonetheless, the underlying analytical point is still valid; holding the nominal funds rate constant in the face of climbing inflation, and presumably inflation expectations, risks making policy progressively more stimulative. This additional stimulation is only partly offset by the further fiscal consolidation assumed in the staff forecast, so that by the end of the Greenbook forecast period, the disequilibrium in monetary policy and the economy is quite evident. The developing situation is reflected as well in results from Taylor rule-type simulations, which tend to show that the federal funds rate is not misaligned at present, given recent inflation and output, but this rate falls below the levels implied by the rule in 1997 and in 1998 if the economy follows the path in the Greenbook forecast.

If the staff is right about the current circumstances, lags in the effect of policy mean that core inflation will edge higher and the unemployment rate lower in the next few quarters, whatever your choice of monetary policy in the near-term. If you share this analysis and assessment and do not want the longer-term outcome of the staff forecast, the sooner you get started on tightening, the less disruptive to the economy will the tightening prove likely to be. Delays would allow underlying inflation pressures to build further and inflation expectations to turn up; the longer this persists, the more total slack ultimately must be put into the labor and product markets to achieve the Committee's inflation objectives. This line of reasoning might motivate an immediate tightening of policy, as in the 50 basis points of alternative C in the bluebook, or by a smaller amount.

Nonetheless, even if the staff forecast were seen as correctly identifying the most likely risks to sustainable expansion, a number of factors could be seen to militate against the need for an immediate tightening. For one, as Ted noted, the recent strength in the dollar will help to damp aggregate demand and price pressures for a time. Moreover, some of the pickup in inflation in 1998 in the staff forecast is a consequence of an assumed event--the drop in the dollar that year--not primarily related to easy monetary policy. The influence of the higher dollar in the near term, along with the still-modest size of the output gap, implies only a slow uptrend in core inflation over the next year. If, in addition, food and energy prices are better behaved this year, as the staff forecasts, overall inflation rates will be damped and hence significantly higher inflation expectations are unlikely to become imbedded in wage and price setting over coming quarters.

Financial markets do not seem to have much concern about an emerging intensification of inflation pressures. Over the near term, their flat-funds-rate expectation may mainly reflect participants' readings of FOMC intentions based on your public statements. But, even over the longer run, most market participants do not seem to see much need for tightening to keep inflation from accelerating: Surveys do not suggest that inflation expectations have moved out of a narrow range, and the overall slope of the yield curve is close to its historic average, suggesting that it mainly reflects a rising term premium. And the surveys and markets may turn out to be right; not only have a number of measures of core inflation been flat or even declining of late, but many of the usual early warning signs of higher inflation have remained quiescent. The Committee may not be able to rule out the possibility that for reasons we do not fully understand the economy may be able to produce at higher levels than we previously thought without added inflation pressures. In these circumstances, the Committee may wish to await further information about prospective inflation before deciding that a firming is needed.

Despite a "wait and see" policy stance at its last few meetings, the Committee has also seen the odds as tilted toward mounting inflation pressures forcing the need to tighten at some point. And the Committee may view the information becoming available since December as leaving that presumption intact. Most importantly, the economy in the fourth quarter was expanding at a rate in excess of the long-run growth of potential, and increases in compensation have been trending higher, confirming tautness in labor markets. In these circumstances, the Committee may see the challenge before it as likely to be how to judge when to tighten policy to head off a potential increase in inflation.

That challenge hasn't gotten any easier. Shifting estimates of the relationships between output gaps and unemployment rates to changes in inflation have reduced the value of these key leading indicators of inflation and confidence in forecasts based on them. And with real interest rates close to historical averages, the reasoning used in 1994 for a preemptive tightening--that the stance of policy had become obviously inflationary--would not seem to be available to guide Committee actions or explain its decisions to the public. The information from the monetary aggregates may be regaining some value, but perhaps not enough to rely on to change policy, and even Taylor-type reaction functions are backward looking in some respects and suspect as well if there is uncertainty about the level of potential.

The difficulty is illustrated by the Committee's experience last year. Growth in real GDP turned out to be more than one percentage point higher, and the unemployment rate about 1/4 point lower, than the members anticipated one year ago, when the Committee took its last policy action. This is the kind of surprise that might typically have been met with a little leaning against the prevailing winds to minimize the risks of overshooting. But uncertainty about underlying relationships, reinforced by the favorable performance of core inflation, stayed the Committee's hand.

Based in part on the statements of Committee members, many in the market believe that the difficulties of predicting inflation in a changing world have become daunting enough to have ruled out preemptive monetary policy action. They believe instead that only a sustained rise in inflation itself--the smoking gun--can trigger a tightening.

But anticipatory policy has served the economy well in the 1980s and '90s, consolidating gains in inflation and prolonging business expansions. Despite the uncertainties, the Committee may still be able to act pre-emptively. Some developments may merit a policy response because if sustained they will inevitably lead to higher inflation. Examples might include continued strong growth that was reducing the unemployment rate appreciably further; signs that labor-cost increases were not going to stop escalating; a sustained pick-up in inflation expectations reflected in prices of financial and real assets as well as in surveys and private forecasts; and movements in the usual set of indicators the Committee has used to detect early that strains on industrial capacity were in the offing.

The more problematic situation to handle pre-emptively would be if economic growth settled back but in reality left the level of output beyond potential, producing a slow, insidious upcreep in costs and prices. With reduced confidence in measures of resource utilization to predict inflation, it might be difficult to confirm that an inflationary process was in train until it became apparent in actual prices. Once that point had arrived, a significant increase in inflation could be under way before policy could reverse it, especially if inflation expectations began to increase. If this is a concern, the Committee may need to act fairly promptly once signs that the economy is producing at a higher than sustainable level begin to emerge but before they were convincing in every respect, being prepared to reverse course if necessary at some later date. One element that might deter prompt action is concern about excessively strong reactions by the public and financial markets to initial tightenings that came as a surprise. For example, this would be a factor to consider with regard to tightening at the current meeting. If the Committee intends to act as pre-emptively as possible, hoping to do so before it sees the smoke from the inflation gun, it might want to consider how it can make its analysis and its intentions as clear as possible to a currently unprepared audience.